

# Taking the Complex and Making it Simple

The Wall Chapter Three: Reading the Tea Leaves

OCTOBER 2022

## Propriété de Grandes Entreprises

Born to a family of artisans, carpenters, and farmers, a young boy left home in the spring of 1835 at the age of 13, traveling 292 miles to Paris. With the Industrial Revolution in full force, the boy was able to find an apprenticeship with a trunk maker and packer and, within a few years, gained a reputation among Paris' fashionable class as one of the city's premier practitioners. After working for many years with royal clients and other elites, he opened his own trunk-making and packing workshop in 1854 at the age of 33. For the next 17 years, he grew his business dramatically through revolutionary innovations like the canvas trunk- which was more durable and lightweight than the traditional leather trunks. He also designed the world's first pick-proof lock.

In 1871, his business came close to ruin due to the Franco-Prussian War. His staff quit, and his tools were stolen. This did not deter him from relocating his shop and rebuilding his brand. Just one year later, he introduced a new line featuring his monogram and a red stripe that would remain his brand's signature long after his death. This is, of course, the story of Louis Vuitton.

This German man inherited the glazier business (cutting, installing, and removing glass) of his father but opted to go into chemistry after completing a four-year apprenticeship in a Frankfurt pharmacy in 1834. His first discoveries were approximately ten years later when he sold nut oils, carbonated mineral water, and lemonade during the European food crisis in the late 1840s. In 1867 our inventor produced a viable powdered milk product, inspired by the high death rate among infants where fresh milk was unavailable, and breastfeeding was considered

an unfashionable option. He later combined his powdered milk with grain and sugar and produced the first version of baby formula after several formulations. While these milk products were an achievement in and of themselves, the milk-condensation process enabled a chocolatier named Daniel Peter to perfect his milk chocolate formulation in 1875. The two men formed a partnership, and in 1879 the Nestle Company was born.

The core of Merlin Wealth Management's Investment Discipline is that the ownership of great businesses over time is the best way to create and maintain wealth. Nowhere in that statement do we say, "the ownership of great American businesses." Many of you have heard me say that I never believed "International" to be an asset class. In my opinion, it is a geography. Asset classes have differing characteristics that should provide diversification and non-correlation. For years, pundits leaned on politics, currency, and the availability of different natural resources as reasons why every investor should have an allocation to international stocks. I know I am a skeptic when it comes to traditional asset allocation in the first place- the idea of requiring an investor to check "boxes" like Large Cap Growth or Mid Cap Value without serious consideration and due diligence on the underlying holdings (if those boxes are being filled with index funds that would require the vetting of thousands of companies) is alien to our nature at MWM. However, I can at least partially connect our view that great companies exist at different places in the business cycle (Emerging Growth, Enduring Growth, Maturing Growth) with the capitalization of those companies (Large Caps are more established, Small Caps emerging). What about International is different other than geography? We have drastic political differences



## By Michael Merlin, Founder of Merlin Wealth Management

Michael's focus has always been on demystifying financial, estate, investment, and philanthropic planning for his clients. With extensive experience in multi-generational planning and advisory techniques, as well as asset management, Michael leads MWM and its clients to partner together and create customized wealth plans that are steeped in the values and best practices of each family. Having built an institutional-quality asset management practice inside MWM, Michael and his team can even align their clients' investment plans with these same best practices.

within the U.S. we don't have to go outside to get that! We also have vast differences in the availability of raw materials across our country; we don't have to go abroad to get that either.

The truth from our vantage point is that international companies should be assessed on the same merits as their U.S. counterparts. Earnings growth, return on equity, balance sheet discipline, competitive moat, and management's track record and ownership level within the business. Over the last 10+ years, the more compelling growth opportunities have been in the United States. That was evident when looking at our forward earnings forecasts after the Great Financial Crisis (GFC) and can now be confirmed by the performance of U.S. stocks versus international stocks since the GFC ended in 2010. From 2011-2021, the S&P 500 Index produced an annualized return of 15.1%. The EAFE Index made a 6.6% return over the same time frame.<sup>1</sup> Furthermore, of the ten largest market cap companies in the world, nine are U.S. companies.<sup>2</sup> Much of our enthusiasm for domestic stocks was due to the generational opportunity afforded to investors to purchase great growth businesses at very attractive prices post-crisis. Looking back, 2010 was likely one of the best opportunities in history to buy U.S. equities.

It seems that a similar financial crisis may be brewing in Europe. A September 6th article from Market Insider framed a brewing predicament for European governments, banks, and utilities. Because of broad price fluctuations, European utilities have \$1.5 trillion of margin calls on hedges used to control costs.<sup>3</sup> That estimate may prove to be conservative, leading to more European capital tied up in securing these derivatives. Assuming the situation is this severe, it would make sense for European governments to step in with support, but they are also being taxed with subsidizing energy costs for the consumer who is having a hard time paying for food, shelter, and transportation. Sweden and Finland have already announced billions in aid to their struggling utilities, hoping to keep liquidity in the energy trading markets. It is not hard to see how this problem could get out of hand. If the utilities can't cover their losses, then the banks that sold them these derivatives are on the hook. While we are all aware of the conservative balance sheets owned by American banks after the GFC, the European banks are not as healthy. As of 9/30/22, the Euro Stoxx Banks Index sported a total debt-to-total asset ratio of 26.7. That compares to the S&P 500 Banks Industry Index at 16.7.<sup>4</sup> Therefore, if these energy losses get worse, it could affect the liquidity of European banks, which would also need support from governments across the EU. Providing financial support to consumers, utilities, and banks is a daunting task for any single government and even more challenging when trying to coordinate such

efforts among 27 potentially. These new funds are also not cheap, with interest rates rising globally. No wonder we are seeing historic lows in the Euro/Dollar and Pound/Dollar exchange rate. Does the market see what we see? While the mainstream financial media focuses on inflation in America, a budding liquidity crisis in Europe could lead to a sharp recession, a la the GFC. Our friend, Ed Hyman, at Evercore ISI, wrote that during every aggressive Fed tightening cycle from 1984-2016, there was a financial crisis of some kind. Each of those events led to a shift in Fed policy. We may be seeing the beginning of this cycle's financial crisis in Europe and the U.K. Further, Bank of America's Global Fund Manager Survey from September 13th showed that managers are the most underweight European equities in the survey's history.<sup>5</sup>

If such a scenario were to play out, it is likely that great European businesses, like the ones mentioned at the outset of this writing, would be priced at levels not seen in decades. MWM will be poised to take advantage of such opportunities, resulting in a higher allocation to non-U.S. companies within our equity strategies than we've seen in over 15 years.

## The Illusion of Knowledge

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**"The greatest enemy of knowledge is not ignorance; it is the illusion of knowledge."**

Daniel J. Boorstin

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A great friend and client of MWM shared an analogy for what is happening in the U.S. economy today. He said that once he had a medical issue that was not caused by the usual conditions that led to this ailment. However, his doctor still prescribed the typical medicine for this condition even though the cause was unusual. Our client declined to take the medication, saying that while it clearly helped in situations triggered by typical causes, his issue did not stem from any of them.

The Federal Reserve is behaving exactly like the doctor in this analogy. Inflation is usually created by an overheated economy, which rising rates can cool. Today, inflation is not being stoked by an overheated economy; it is present because of an unprecedented increase in money supply, a drastic reduction in immigration which has crimped the labor force, and severe supply chain issues across many sectors and industries (energy the most popular one). None of these conditions will be solved by rising rates. Why, then, is the Fed embarking

on such an aggressive rate-rising campaign? The simple answer is that the Fed hasn't been very good at predicting where interest rates are headed months into the future. They were wildly accommodative in 2020 and 2021 and are now trying to rectify that mistake by delivering tough talk and heavy-handed policy to show that it means business. These missteps are so egregious that Wharton professor Jeremy Siegel said he feels that this could be "one of the biggest policy mistakes in the 110-year history of the Fed."<sup>6</sup>

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The data shows that the Fed is likely to get it wrong again. The money supply has already contracted from a break-neck growth rate of 40%+ in 2020 to -1% in September 2022. That shift alone should be enough to bring inflation back to 2% to 2.5% a year from now. However, Chairman Powell recently said, "monetary aggregates don't play a role in the formulation of policy...the relationship between money supply and inflation has been less stable than it was in [Milton] Friedman's day."<sup>7</sup> This is an extraordinary statement; is Powell saying that the Fed does not include changes in the money supply in the data that "drives" Fed decisions? That may be why the Fed completely missed the current inflation in its forecasts last year, and it almost guarantees the Fed will be wrong the other way this year.

In addition to the money supply, there are many other signs that inflation is cooling: Rents are declining; Commodity prices are falling; Used car prices are weakening; Shipping freight rates are down; Trucking freight rates are down. Yet, so far, the Fed is not impressed by these signs.

The bottom line is that it is hard to imagine a scenario where U.S. equities perform well while the Fed keeps raising interest rates. Furthermore, the Fed seems intent on pressing forward with aggressive policy moves

despite signs that the increases they've already made haven't shown up in the headline data but are having significant effects on corporate earnings and consumer spending. The scenario makes it hard to see how the U.S. economy will avoid recession in 2023. However, with 3rd quarter earnings season upon us, we will see how much of an impact there is on companies and how they forecast their profit and earnings growth for the remainder of the year. In a typical recession, companies tend to revise their earnings down by 15%-20%, putting S&P forward earnings at \$200. If we place a 17x multiple on those earnings, the S&P 500 Index could test 3,300-3,400 before a bottom is detected. If earnings reports are more optimistic, or if the Fed somehow finds religion and pauses or reverses policy, the bottom could be identified much sooner. We are not counting on either of these developments.

## **MWM Positioning**

David Rubenstein, the co-founder and co-chairman of private equity firm The Carlyle Group, recently wrote a book titled, "How To Invest: Masters on the Craft." In the book, Rubenstein shares the top three traits of a great investor:<sup>8</sup>

1. The ability to defy conventional wisdom and hold on to investments for a long period of time
2. The capacity to admit an investment mistake and recover quickly
3. An intellectual curiosity that exceeds the average person, reading enormous amounts of material, even on subjects not related to investment activity

I do not feel like it is a stretch to say that MWM has exemplified these traits within our proprietary asset management business. Owning great companies for a long period of time is at the center of our investment discipline, which in and of itself defies conventional wisdom. It was also not easy (or conventional) to recommend the overweight to equities back in 2010 when the world was still reeling from the GFC. The current environment will likely provide another opportunity to act unconventionally. Whether it is in Europe/U.K., as I described above, or opportunities to add to our existing names, or private investments (another area where we do not conform to the status quo), there is no doubt in my mind that opportunities will abound from the pain and uncertainty we are currently experiencing.

After reading Peter Zeihan's book, *Disunited Nations* (Harper Business, 2020), our July 2020 quarterly titled "Complacency Breeds Failure: Only the Paranoid Survive-Corona Virus Part 3" outlined our view that while China was legitimately America's biggest adversary in the geopolitical and geoeconomic world, they were doing it

all wrong. This was not an "investment" call per se, but the book significantly impacted us from several standpoints. First, it reminded us that China's economy was built on a mountain of debt, which would eventually curtail the break-neck GDP growth coming from the country. This year we saw the implosion of several Chinese real estate firms, the most publicized was Evergrande which collapsed under \$300 billion in liabilities. It was quite popular in 2020 for asset managers to increase their exposure to Chinese investments- many institutional asset management firms recommended a specific allocation to China, above and beyond their allocation to international stocks in general. MWM pivoted the other direction, selling the Chinese companies we owned based on our concerns about the macroeconomic underpinnings of the Chinese economy and the strained political relationship between President Xi and President Trump.

Another conclusion we reached from our analysis of Zeihan's book is that while the U.S. may not be seen as a superpower the way it was 15-20 years ago, it was still the best house in a bad neighborhood. While other countries struggle, America will struggle less. Our economic moat, highly functional and efficient markets, and financial system stability will always be an attractive place for the most talented citizens of other countries to seek asylum. We thought this would apply to Chinese citizens when we wrote it in 2020, but we now see an interesting potential application of this theory due to the war in Ukraine. More on that later.

purchased put options (on the S&P in CORE and INC and the Nasdaq in ERA) as well.<sup>9</sup> Our current positioning is as defensive as we have been since the GFC in 2008-2009. September was a different result for us, as the market declined close to -9% for the month, but our strategies were only -6.1% (CORE), -5.4% (INC), and -5.8% (ERA) because of this defensive stance.<sup>10</sup>

The roller coaster-shaped market movements this year will likely continue into 2023 as investors contend with the balance of headwinds and tailwinds affecting market sentiment. Fed policy is the largest headwind, which compelling valuations have temporarily offset at market lows. We've seen signs that liquidity is drying up across different parts of the financing market but are also confident that the U.S. banking system is as strong as it has ever been. High inflation impacts consumer spending and sentiment but is offset by a strong labor market and low unemployment. Classic recessionary signals abound, but revenue and earnings expectations have exceeded typical recessionary adjustments so far. Lastly, while heightened geopolitical tensions remain, supply chains are starting to recover, which is a huge factor in the fight against inflation.

Among all this uncertainty, we've received a few calls questioning why we haven't changed our tactics more drastically—selling larger chunks of our top holdings; holding more cash. These short-term decisions would have likely been accompanied by more short-term pain

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As for admitting mistakes and recovering, this is a constant for us. I don't think any good asset manager goes through a single investment year without feeling like they made many mistakes. The most recent for MWM was not taking the Fed seriously enough in January 2022. We thought that the Fed would raise rates, but not dramatically. While we felt that was more can-kicking of larger problems related to the massive amount of money printed by the federal government during the pandemic, we didn't think the Fed had the intestinal fortitude to do what was necessary to take that problem head-on, especially in an election year. Clearly, we were wrong.

As a result, we were not adequately hedged for the market low reached in June, but we rectified that posturing quickly. After a relatively strong rally in July and August, we raised cash to 12.2% (CORE), 9.2% (INC), and 21.0% (ERA) across the three equity strategies and

reduction. However, I am reminded of a great quote from Robert Glazer's Friday Forward titled, Deciding Values. "Compromising values to make a decision with a short-term benefit is easy to do. But values don't mean anything if you're willing to toss them aside when it's convenient. The truest test of a value is when you are willing to make a decision that has a measure of short-term pain or consequences because you are unwilling to compromise. That's the best definition of integrity I know."<sup>11</sup>

The ideology behind our investment discipline is still very much alive and well. While short-term conditions have inflicted more than our fair share of pain, our long-term track record proves the age-old quote from Warren Buffett's mentor Ben Graham that "in the short run, the market is a voting machine, but in the long-run, the market is a weighing machine," taking into account the quality and fundamental strengths of great businesses.

## Asset Allocation in Focus: Fixed Income and Infrastructure

Ken Griffin, the founder of hedge fund Citadel, declared the 60/40 portfolio alive and well at the CNBC Delivering Alpha conference on September 28th.<sup>12</sup> Many professional investors proclaimed the 60/40 portfolio dead over the last decade, as paltry yields on fixed income essentially rendered the strategy useless. So, a career hedge fund manager highlighting such a simple strategy as a favorite was certainly newsworthy.

The problem with the 60/40 portfolio has been that bonds have provided essentially zero yields for the last ten years, and the likely Fed move was eventually higher, meaning the bonds would not offer the usual "hedge" when equities fell. However, now that 10-year yields are close to 4%, if the economy does enter a recession, forcing the Fed to become more accommodative, then suddenly, those bonds would be worth more than they are today, providing a solid hedge and a very acceptable yield in the meantime.

As we've been communicating all year, our focus has been on returning client asset allocations to normal levels; removing the significant overweight to equities we initiated in 2010. That process will continue and allows us to take advantage of the higher yields in the treasury market, the corporate bond market, and the municipal bond market. We are also likely to take our bond portfolio durations longer. Our thesis is that the Fed will eventually have to reverse course and lower rates once their painful demand destruction campaign forces the U.S. economy into a recession.

Currently, we are seeing yields over 4% in the treasury market and the investment grade corporate bond market for bonds two years or longer. In the municipal bond market, we are finding bonds paying 3%-4% tax-free with 5 to 7-year maturities and 2 to 3-year call options. Because our current duration has been so short, we can take advantage of these attractive yields since we have bonds maturing and new cash coming into bond portfolios from the rebalancing mentioned above. In 2010 we pledged to you that when bonds were once again attractive, we would be rightsizing asset allocations to reflect that. We are now seeing those conditions unfold.

A final note on the Core Municipal Portfolio (COMP) and Corporate Bond Portfolio (CORP): due to our positioning, the performance of both portfolios have significantly exceeded their respective benchmarks. COMP was -5.9% through 9/30/22<sup>13</sup> versus its comparable benchmark at -8.8% and the Blackrock Municipal Income Fund at -25.6%.<sup>14</sup> CORP was -7.8% versus its benchmark at -14.6%<sup>15</sup> and the iShares Investment Grade Corporate Bond ETF at -21.2%.<sup>16</sup>

## Investing in Infrastructure

In addition to the opportunity in the fixed-income market due to our short-duration positioning, we are also benefitting from our growing allocation to real estate, as real assets tend to perform well in an inflationary environment. Another type of real asset that typically performs well in an inflationary environment is infrastructure. Infrastructure investments cover many things needed to service a growing global population—reliable energy transmission, increased communication bandwidth, clean drinking water, and transportation.

Recent developments, including the massive investment in data infrastructure, the global push toward decarbonization, and the midstream energy production sector falling out of favor due to ESG concerns, are playing out amid longer-term trends such as aging utilities that require significant capital upgrades and governments worldwide seeking solutions to their ballooning debt.

Given their essential nature, these assets often provide investors with stable and secure cash flows, downside protection, diversification from other asset classes, and inflation protection. By focusing on essential operating assets, an infrastructure strategy should be resilient in most economic environments. While we believe infrastructure is compelling for investors across various market conditions, today's climate appears to be particularly rife with opportunity.

As such, we will begin implementing an infrastructure allocation for clients, using publicly traded and private investment options.

## The Workforce Innovation and Opportunity Act: After 60 years, Why Can't We Get This Right?

Nothing is more elemental to the American Dream than the opportunity to find rewarding work that matches a skill set and lifestyle goals. In fact, the allure of American jobs and the life that can develop from working hard in our country is one of the main reasons the U.S. benefits from the immigration of talented workers from other countries. As mentioned earlier, it is a long-standing and recurring theme for the most talented workers in other countries, especially those faced with human rights violations, geopolitical upheaval, wars, or genocide, to migrate to America for asylum and the opportunity to pursue the dream.

In our Summer 2021 piece, we posited that a similar style exodus could come from China, and that still may happen. But once the first shot was fired in the Russia-Ukraine war, it became clear that the first swath of talented immigrants may be Russian and Ukrainian. Increasing immigration would help ease wage inflation more productively than raising interest rates. More workers should bring down

labor costs by increasing the labor supply available to employers. In contrast, interest rate increases will destroy demand, cause companies to lay off workers, and almost certainly push our economy into a recession.

Famed hedge fund investor Bill Ackman recently tweeted, "Let's remove the barriers for Russia's brightest, the most talented Russians must leave now before they become fodder in an unjust war. Doing so saves our economy and destroys Russia's future."<sup>17</sup> Inviting more Russians and other foreign nationals into the country would bolster the domestic labor supply and ease the upward pressure on wages.

We currently have over 10 million jobs available in the U.S., with approximately 8 million unemployed workers actively seeking employment. This mismatch comes down to workers' skill sets not pairing with available opportunities and therefore requiring that we rely on immigration to fill gaps that U.S. workers won't fill. Unfortunately, this is not a new problem. The government has been trying to address job training and retraining for over 60 years with mixed results. The first substantial federal training programs were enacted in the Manpower Development Training Act in 1962 and have been amended four times- in 1973, 1982, 1998, and most recently in 2014 through the Workforce Innovation and Opportunity Act. This federal system requires each state to establish a one-stop delivery system to:

- Provide "career services" and access to "training services."
- Provide access to programs and activities carried out by partners (potential employers).
- Provide access to all workforce and labor market information, job search, placement, and labor exchange services.

While positive changes have been made to the program over the 60 years since its origin, the results have disappointed most American employers. During the debate surrounding the 2014 amendment, Senator Lamar Alexander (R-TN) said that "it's [still] too hard to find a job. It's [still] too hard to create a job. We have some differences of opinion on what to do about it, but I think we agree that matching job skills to a job is a solution to millions of Americans." Senator Jack Reed (D-RI) said that "the need to improve our workforce investment system has crystalized.... employers say they have open positions they cannot fill because they cannot find workers with the skills they need today." These comments, and many others like them, were made years before and years after the Workforce Innovation and Opportunity Act was passed. So, why are we still failing to get American workers the proper training for today's jobs?

In typical fashion, with a government-run program, it comes down to bureaucracy. First, the program is only allocated a total of \$10 billion, divided among all 50 states. By comparison, Congress recently budgeted \$80 billion to hire 87,000 new IRS agents to beef up the agency's enforcement efforts. Worse than underfunding, however, is the method by which the funds are allocated. The program allocates funds to states based on population and unemployment rate, paying no attention to where jobs are available or where training opportunities are especially ripe. For example, suppose an electric car company announced it was building a manufacturing facility in Georgia, and required 2,500 specialized workers. In that case, there is no more money from WIOA [Workforce Innovation and Opportunity Act] in that particular year. Furthermore, why should a state like Utah be penalized for having a 2% unemployment rate if Delta Airlines decides it wants to hire 1,000 workers that require specific skills? Finally, do we believe that state agencies are the best execution force for this critical initiative?

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## **"Government should be a referee, not an active player."**

Milton Friedman

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As Milton Friedman said, "government should be a referee, not an active player."<sup>18</sup> If we genuinely want to get serious about worker training, retraining, and matching the skill sets of the unemployed with the job opportunities open and required to keep our economy growing, then we should be putting the funds allocated to this project in the hands of private industry in the form of grants. For example, Amazon could apply for a federal grant for its Career Skills program- a free, on-site training and development program available to all hourly Amazon employees. With these funds, Amazon could expand this fantastic program which teaches resume building, interviewing skills, effective speaking, time management, and Microsoft Excel training, to name a few of the available classes. I feel Career Skills by Amazon might be more effective than the next iteration of the WIOA, don't you?



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Disclosures

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**Important Information.** For comparison purposes, the Composite is measured against the S&P 500 Index. The S&P 500 Index measures the performance of the large cap segment of the U.S. equities market, covering approximately 80% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy. The index is unmanaged and do not reflect commissions or fees that would be incurred by an investor pursuing the index. It is not possible to invest directly in the index.

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